BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MORTHRIFT PLAN)

Appearances:

For Appellant: Arnold Rue
Attorney at Law

For Respondent: A. Ben Jacobson
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Morthrift Plan against pro-posed assessnents of additional franchise tax in the amountsof $3,806.00, $1,959.83, $1,619.49, and $1,403.45 for the income years 1957, 1958, 1959, and 1960, respectively,

Appellant was incoroorated in California in 1921 and 'has continuously engaged in business in this state since that time, It is authorized to conduct business as an industrial loan company under the Industrial Loan Law. (Fin. Code, 6 §18000-188 58,) Appellant is subject to the supervision and control Of the Commissioner of Corporations of tne State of California. (Fin, Code, §§ 18002, 18400.)

Appellant makes unsecured loans and loans secured by real and personal property. It also purchases trust receipts and conditional sales contracts. The maximum loan term, except for government insured loans, is limited by law to three years. (Fin. Code, §§ 18406, 18406.1, 18669.) During the income years in question, appellant was allowed to purchase trust receipts or conditional sales contracts which matured in three years or less. (Fin. Code, § 18405.) Appellant also issues and sells "investment certificates" as authorized by

section 18432 of; the Financial Code, Appellant is specifically denied the right to accept money for "deposit" or to issue "certificates of deposit," (Fin. Code; § 18403.).

For the years here considered, appellant claimed 2s bad debt deductions the amounts of certain yearly additions to its bad debt reserve acoount. Appellant's outstanding loan balances, yearly additions to its reserve, book reserve balances, and actual net bad debt losses mitten off for the years in question were as follow:

	Out standing Loans	Addition to Reserve	Balance of Reserve	Net Losses
1957	$5,528,726.42	$ 51,006.92	$119,346.36	$ 18,013.93
1958	5,413,227.78	25,127.94	116,736.51	39,630.73
1959	7,036,751.74	73,620.35	159,072.65	45,208.37
1960	7,001,796.54	62,476.31	174,628.12	38,928.08

Respondent determined that a reasonable addition to the reserve was the amount required to bring the reserve balance to seven tenths of 1 percent of the balance of loans outstanding. Appellant's claimed bad debt deductions and the mounts allowed by respondent are as reflected by the following table :

	Claimed	Allowed
1957	$ 51,006.92	-0-
1958	25,127.94	$ 5,751.96
1959	73,620.35	56,573.04
1960	62,476.31	38,683.40

Section 24348 of the Revenue and Taxation' Code- reads in pertinent part as follows:

> There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts ....

The issue presented is whether respondent abused its discretion in refusing to allow the tot21 amounts deducted by appellant as additions to its bad debt reserve. Respondent's determination is presumed correct and appellant has the "heavy burden" of showing that the amounts allowed were not reasonable additions, (S. W. Coe & Co. v. Dallman, 216 F. 2d 566.

Appellant's principal contention is that it is a bank and that additions to its reserve account were within the guidelines prescribed by the United States Commissioner of Internal Revenue in Mimeograph 6209, 1947-2 Cum. Bull. 26, and Revenue Ruling 54-148, 1954-1 Cum, Bull. 60. These releases provide that a bank using the reserve method may make an annual addition to its bad debt reserve based upon a moving or fixed average of its total bad debt loss experience for a p-eriod of 20 years for federal income tax purposes. Mimeograph 6209 states that:

> The term "banks" as used herein means banks or trust companies incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts,

Revenue Ruling 54-148 added the following sentence to the definition of "banks":

> Such term as used in Mimeograph 6209 and herein does not include mutuai savings banks not having capital stock represented by shares, domestic building and loan associations, or coop erative banks without capital stock organized and operated for mutual purposes and without profit.

Before the adoption of Mimeograph 6209, respondent had in force a ruling similar to it, which was applied to national and state banks. On June 16, 1961, respondent published a letter stating that:

> From time to time we receive inquiries as to the Franchise Tax Board's position as to reserves for bad debts for banks .... At a meeting of the Franchise Tax Board January 31, 1956, the Board authorized the application of Internal Revenue Service Ruling 54-148 to cases arising under the Bank and Corporation Tax Law. Prior to this time the Board had been following the provisions of Internal Revenue Service Com.--Mimeograph Coll. No. 6209. In effect the Board's present practice is to follow Mimeograph 6209 as modified by Revenue Ruling 54-148.

Appellant submits that its additions to its reserve must be approved since for franchise tax purposes respondent has authorized the use by banks of the method prescribed by the federal rulings, it is respondent's position that appellant is not a bank, that it did not actually use the method prescribed for banks to compute additions to its reserve, and that appellant has not demonstrated that respondent abused its discretion.

As authority that it is a bank, appellant relies on federal cases holding that industrial loan companies are banks for excess Profits tax purposes. (Staunton Industrial Loan Corp. v. Commissioner, 120 F.2d 930; Commissioner v. Valley Morris Plan, 305 F.2d 610.) The definition of a bank considered by those courts is in section 104(a) of the Internal Revenue Code of 1939 (now section 581 of the Internal Revenue Code of 1954).

Although the definition of a bank set forth in Mimeograph 6209 and Revenue Ruling 54-148 is substantially similar to the definition contained in the above sections of the Internal Revenue Code, it is by no means clear that an industrial loan company is a bank within the meaning of the mimeograph and revenue ruling. Contrary to the cases cited by appellant, it has been held by another federal court that an industrial loan company was not a bank under section 104(a) of the Internal Revenue Code of 1939. (Jackson Finance & Thrift Co. v. Commissioner, 260 F.2d 578.) It has also been held that an industrial loan company was not a bank under the Securities Act of 1933, which defined a bank as an institution whose activities were "substantially confined to banking." (Capital Funds, Inc. v. Securities & Exchange Comm., 348 F.2d 582.)

In our opinion, respondent did not abuse its discretion in refusing to classify appellant as a bank for purposes of computing additions to appellant's bad debt reserve. In view of the ambiguity in the definition of a bank in Mimeograph 6209 and Revenue Ruling 54-148, respondent's published letter stating that "in effect" it follows that mimeograph and ruling, did not commit respondent to treat appellant as a bank. Appellant is not a bank as defined in the California Banking Law (Fin. Code, § 102), nor is it regulated by the State Banking Department It is expressly prohibited from accepting "deposits" (Fin. Code, § 18403) and, unlike banks recognized as such under the California Banking Law, its uninsured loans are limited to three-year terms. (Fin. Code, §§ 18405, 18406, 18406.1, 18669.) We conclude, therefore, that respondent had sufficient reason to distinguish appellant from banks, which are permitted to use 20 years of loss experience to compute additions to their bad debt reserves.

The question remains whether in the absence of the automatic application of the method prescribed by Mimeograph 6209 and Revenue Ruling 54-148, appellant is nevertheless entitled to the deductions under the statutory standard of a "reasonable addition." Since reasonable additions are allowable at the discretion of respondent, appellant must show that the additions allowed by respondent were unreasonable. (Paramount Finance Co. v. United States, 304 F.2d 460.) Where the reserve allowed is adequate in the light of prevailing conditions to cover current anticipated losses there is no abuse of discretion, (American State Bank v. United States, 176 F. Supp. 64, aff'd, 279 F.2d 585; Krim-Ko Corp., 16 T.C. 31.)

Following these guides, it is apparent that the additions allowed by respondent were reasonable. The record discloses that the balance in the reserve as allowed by respondent was at all times sufficient to cover actual losses. During the years in question, *larger* additions could not have been justified on the basis of appellant's then recent loss experience and no facts have been presented to show prospects of future losses greater than the reserve allowed.

Appellant has compared the ratio, of its reserve to loans outstanding with that of other loan companies and has submitted financial statements which tend to show that its reserve was comparable to that of other industrial loan companies. It has also pointed out that the California Commissioner of Corporations required, a reserve greater than that allowed by respondent.

Evidence that other industrial loan companies maintained comparable bad debt reserves has little relevancy since appellant's additions must be based upon its own loss experience and *a* forecast of losses in the light of its peculiar business conditions. (Financial Credit Corp. v. United States, 235 F. Supp. 274.) The record, moreover, does not disclose that respondent has approved the reserves of the other loan companies for tax purposes.

The reserve requirement set by the Commissioner of Corporations likewise has little bearing on the reasonableness of the additions for tax purposes. The Commissioner's judgment, which was exercised for other than tax purposes, is not questioned. His judgment, however, may not be substituted for that of respondent, which alone is charged with administration of the Bank and Corporation Tax Law. In Appeal of People's Federal Savings and Loan Ass'n, Cal. St. Bd. of Equal., June 24, 1957, we stated that reserve requirements for the protection of the public were not controlling for the tax purpose of computing net income. (See also, Bellefontaine Federal Savings and Loan Ass'n, 33 T.C. 808.)

We conclude that respondent did **not** abuse its discretion in reducing appellant's additions to its bad debt reserve.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Morthrift Plan against proposed assessments of additional franchise tax in the amounts of $3,806.00, $1,959.83, $1,619.49, and $1,403.45 for the income years 1957, 1958, 1959, and 1960, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of February, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Secretary